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No. 97-1418

IN THE

Supreme Court of the United States

OCTOBER TERM, 1997

BANK OF AMERICA NATIONAL TRUST AND SAVINGS ASSOCIATION,

Petitioner,

v.

203 NORTH LASALLE STREET PARTNERSHIP,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

BRIEF OF THE *AMICI CURIAE* AMERICAN BANKERS ASSOCIATION AND CALIFORNIA BANKERS ASSOCIATION IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether the Bankruptcy Code authorizes the confirmation of a Chapter 11 plan of reorganization that provides that existing equity owners will contribute "new value" to the reorganization and will own equity in the reorganized debtor, even though the plan does not provide for full payment to a senior, objecting class of unsecured creditors.

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[1] No counsel for any party had any role in authoring this brief and no person other than amici curiae made any monetary contribution to its preparation or submission.

In accordance with the provisions of Rule 37.3(a) of the Supreme Court Rules, the American Bankers Association and California Bankers Association hereby respectfully submit this brief as amici curiae in support of the Petitioner. Both parties have consented to this filing and their written consents are filed together with this brief.

INTEREST OF THE AMICI CURIAE

The American Bankers Association is the principal national trade association of the banking industry in the United States. Its membership includes both commercial banks and thrift institutions located in each of the fifty states and the District of Columbia, and those institutions hold approximately ninety percent of the domestic assets of the industry.

The California Bankers Association is the principal state-based trade association for the lending industry in California, representing virtually all of the commercial banks and trust companies in that state.

Both associations frequently appear in litigation either as a party or as amicus curiae in cases raising issues of widespread importance to their members.

Litigation over the existence or nonexistence of a "new value exception" to the absolute priority rule in bankruptcy is of considerable concern to the Associations' members. Since virtually all debtors are insolvent, the costs of bankruptcy fall almost exclusively upon creditors, many of whom are represented by your amici. The "exception," if it is found to exist, (despite the fact that it can be found nowhere in the statutory language), will prove costly and disruptive, irreconcilable with the priorities Congress set down in the statute in favor of a vague standard that cannot

be administered in a fair and equitable manner, and ultimately transfers reorganization value from creditors (where Congress said it belongs) to existing owners.

SUMMARY OF THE ARGUMENT

The dispute among the lower courts and the commentators over the existence of a "new value exception" to the absolute priority rule in bankruptcy is often phrased in the form of a question whether the "new value exception *survived* passage of the Bankruptcy Code." *Matter of 203 N. LaSalle St. Partnership*, 126 F.3d 955, 963 (7th Cir. 1997)(emphasis added). To phrase the issue that way, however, is to overstate the alleged "exception's" pedigree, and thus to lead into errors in logical analysis and in application of this Court's precedents.

It is acknowledged that this Court is, and has been, "reluctant to accept arguments that would interpret the Code...to effect a major change in pre-Code practice that is not the subject of at least some discussion in the legislative history." *Dewsnup v. Timm*, 502 U.S. 410, 419 (1992). *See also United Savings Association v. Timbers of Inwood Forest Associates*, 484 U.S. 365, (1988). We ask the Court to do no such thing here. Prior to the enactment of the Bankruptcy Code in 1978, there never really was any fixed, definable or coherent "new value exception" to the absolute priority rule that could be or was applied in bankruptcy proceedings. The 1978 Code changed the nature of reorganizations so extensively that it is fair and accurate to say that prior to 1978, no "new value exception" had ever been or could have ever been applied to the kind of reorganization at issue in the present proceeding. Moreover, the legislative history of the 1978 Code is not devoid of any mention of a "new value

exception" to the absolute priority rule. Quite the contrary, there was a highly prestigious recommendation that Congress adopt an exception--a recommendation that Congress did not follow. Finally, Congress has carved out exceptions to the absolute priority rule in certain bankruptcy matters, thereby clearly showing that it knows how to do so when that is its intention. Those exceptions do not apply to the case at hand, and it must therefore be concluded that Congress did not intend for them to apply here.

ARGUMENT

I. History of the Absolute Priority Rule in the Courts

The "rule" that a debtor's creditors must be paid in full before the debtor's owners can retain any value has its genesis in railroad reorganizations of a century ago. In the absence of a federal bankruptcy statute at the time, such reorganizations took place in the form of equitable receiverships. In *Louisville Trust Co. v. Louisville N.A. & C. R. Co.*, 174 U.S. 674 (1899), a secured lender foreclosed on a railroad's property, thereby wiping out the interests of junior unsecured creditors, and yet apparently (and mysteriously), at least some equity ownership interest in the railroad was maintained by at least some stockholders. The unsecured creditors suspected collusion and attempted to challenge that outcome. The lower courts disallowed the challenge, but this is Court reversed, holding that "the stockholder's interest in the property is subordinate to the rights of creditors; first, of secured, and then of unsecured, creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of

prior rights of either class of creditors comes within judicial denunciation." *Id* at 684. "It is one thing for a bondholder who has acquired absolute title by foreclosure to mortgaged property to thereafter give of his interest to others, and an entirely different thing whether such bondholder, to destroy the interest of all unsecured creditors, to secure a waiver of all objections on the part of the stockholder and consummate speedily the foreclosure, may proffer to him an interest in the property after the foreclosure. The former may be beyond the power of the courts to inquire into or condemn. The latter is something which on the face of it deserves the condemnation of every court." *Id*. at 688.

The unsecured creditors having thus acquired rights that they could protect, it became necessary to determine the scope of those rights, still without benefit of applicable federal bankruptcy law. This Court began to do so in *Northern Pacific Railway v. Boyd*, 228 U.S. 482 (1913), in which a balance was struck among the desirability of continuing to operate a railroad (instead of dismantling it), the need for funds to do so (recognizing stockholders as the most likely source of those funds) and the unsecured creditors' rights. The Court said that it was not "necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company. His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer, he is left to protect himself as any other creditor of a judgment debtor; and having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it." *Id*. at 508.

But that, of course, left open the question of what constitutes a "fair offer." Two definitions were suggested

and debated: a rule of "absolute priority which recognized state law claims and did not permit owners to participate in the reorganized debtor unless those claims were satisfied in full, and a rule of "relative priority" which permitted owners to participate if earnings met certain levels and relative priorities among classes were observed.[2]

II. Legislation and the *Case* Case

Finally, Congress entered the picture. In 1933, it added Section 77 to the Bankruptcy Act of 1898, pertaining to railroad reorganizations (Act of March 3, 1933, Ch. 204, § 77, 47 Stat. 1467, 1474 (1933)). A year later, it added Section 77B to the Act, pertaining to other kinds of corporations (Act of June 7, 1934, Ch. 424, § 77B, 48 Stat. 911, 912 (1934)). While the two new sections of the law differed in some respects, both required that plans be "fair and equitable" as to each creditor and that all classes of affected creditors accept the plan by the required class vote. In *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939) this Court held that those words, "fair and equitable," were "words of art which...had acquired a fixed meaning through judicial interpretations in the field of equity receivership reorganizations." *Id.* at 115. Those "judicial interpretations" included, according to the Court, *Louisville Trust* and the "fixed principle" of *Northern Pacific Railway* (*id.* at 115-116) which the Court further described as "this rule of full or absolute priority." (id. at 117).

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[2] Markell, *Owners, Auctions and Absolute Priority in Bankruptcy Reorganizations*, 44 Stanford L. Rev. 69, 82; 6A *Collier on Bankruptcy*, ¶ 11.06 (14th ed. 1978)

In *Case*, the lower courts had approved a reorganization plan in which old stockholders were entitled to some 23% of the reorganized company in return for the intangible value they would contribute to the reorganization: familiarity with the operation of the business, financial standing and influence in the community, and continuity of management. The Supreme Court agreed that the plan would have maintained the "relative priorities of the bondholders and stockholders." Id. at 112 and 119. But that was not the test, for even "the payment of cash by the stockholders for new stock did not [in *Kansas City Terminal R. Co. v. Union Trust Co.*, 271 U.S. 455] itself save the plan from the rigors of the 'fixed principle of the [*Northern Pacific v.*] Boyd Case, for in that case the decree was struck down where provision was not made for the unsecured creditor and even though the stockholders paid cash for their new stock. *Case*, *supra*, at 117.

Having rejected the "relative priorities" approach to adjusting the interests of owners, secured creditors and unsecured creditors in favor of a "full or absolute priority" rule, having accurately discussed the Court's own precedents holding that even cash contributions to a plan by old stockholders could not place their interests ahead of unsecured creditors, and having then rejected the plan of reorganization actually at issue in *Case*, the opinion of the Court then goes on to express a belief that a creditor is afforded "his full right of priority against the corporate assets " if the stockholder's participation is "based on a contribution in money or in money's worth, reasonably equivalent in view of all the circumstances to the participation of the stockholder." *Id.* at 122.

Self-evidently, this brief discussion in the Court's opinion of the need for there to be a contribution in money or in money's worth in order for stockholders to participate in a reorganization plan is mere dicta.[3] The Court had no occasion to examine, in *Case* or thereafter, a plan in which such a "contribution" was made, and what might be the "circumstances" under which such a contribution might justify a re-ordering of priorities to the detriment of unsecured creditors senior to the interests of the stockholders, nor did it discuss how a "new Value" rule could co-exist with an *absolute* priority rule. And yet, this dicta is the entire source of the alleged "new value" exception to the absolute priority rule. No subsequent decision of this Court has upheld, as "fair and equitable," a plan providing for owner participation where senior claims were not satisfied in full.[4] Indeed, there do not appear to be any pre-Code published opinions at all in which the dicta was adopted so as to confirm a "new value" plan over the

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[3] This Court has cautioned that there is a "need to distinguish an opinion's holding from its dicta." *U.S. National Bank of Oregon v. Independent Insurance Agents of America*, 113 S. Ct. 2173, 2186 n. 11 (1993).

[4] *See Consolidated Rock Products Co. v. DuBois*, 312 U.S. 510 (1941); *Marine Harbor Properties, Inc. v. Manufacturer's Trust Co.*, 317 U.S. 78 (1942); *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pacific Railroad*, 318 U.S. 523 (1943). *See also Mason v. Paradise Irrigation District*, 326 U.S. 536 (1946) in which the courts did confirm a "new value" plan, but it was one in which the "new value" was contributed not by equity owners, but rather by a creditor.

objection of a dissenting creditor.[5] That being so, it was error for the Seventh Circuit to conclude that *Case* "for more than fifty years, the new value precept has been recognized as an important corollary or exception to the absolute priority rule," *LaSalle*, 126 F.3d at 965, so as to invoke the *Dewsnup* "rule" against implied *major* changes in pre-Code practice.

The absolute priority rule was not without its problems. Sections 77 and 77B of the Bankruptcy Act provided creditors with the right to vote by class on reorganization plans and required that a reorganization plan be fair and equitable as to *each* creditor. This effectively allowed tiny minority class members to block confirmation of plans by convincing the court that the plan was unfair or inequitable as to them.[6] The absolute priority rule thus lacked the flexibility that had been present in equity receiverships. That was a problem which Congress recognized and upon which it sought advice.

III. The 1978 Bankruptcy Code

In 1970, Congress created the Commission on Bankruptcy Laws of the United States, Pub. L. No. 91-354, charged it with studying the existing system and proposing any necessary changes to it. Among other

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[5] Ayer, *Rethinking Absolute Priority After* Ahlers, 87 Mich. L. Rev. 963, 1016 (1989); Klee, *Cram Down II*, 64 Am Bankr. L. J. 229, 241 (1990).

[6] This is precisely what happened in *Case*, in which the Supreme Court disallowed a plan of reorganization though it had been approved by majorities of 90% or more of the vote of various classes. *Case*, 308 U.S. at 111

things, the Commission specifically evaluated the judicially created absolute priority rule. When it made its report to Congress in 1973, it recommended that the rule be modified "by allowing stockholders to participate (in a reorganization plan) if their future contribution, i.e., continued management, is essential to the business." Report of the Commission of the Bankruptcy Laws of the United States, H.R. Doc. No. 137, 93d Cong. at 254-259 (1973). The Commission's draft of legislation designed to relax the absolute priority rule contained a Section 7-303 which, according to the explanatory notes, "allows the court to confirm, where the plan allows participation by ownership not permissible under the absolute priority test, if the participation is supported by, *e.g.*, continued management; this adopts the District Court's opinion which was reversed in *Case v. Los Angeles Lumber Products Co.*" *Id.* at 254.

While it is clear that the Commission recommended an exception to the absolute priority rule that is broader than the one at issue in this case, the fact of the matter is that Congress elected to codify the absolute priority rule when it enacted the Bankruptcy Code in 1978, and did so without making *any* exceptions to it, though it obviously knew there was a respectable constituency for exceptions.

In its Report on the Bankruptcy Code, the House of Representatives Committee clearly expressed its intent that the bill would closely adhere to the existing absolute priority rule:

> [T]he bill requires that the plan pay *any* dissenting class *in full* before *any* class junior to the dissenter may be paid *at all*. The rule is a partial application of the absolute priority rule now applied under Chapter X and requires a full

> valuation of the debtor as the absolute priority rule does under current law. The important difference is that the bill permits senior classes to take less than full payment in order to expedite or insure the success of reorganization.

H.R. Rep. No. 595, 95th Cong., 1st Sess. at 224 (1978) (emphasis added).

> The general principle of the subsection permits confirmation notwithstanding nonacceptance by an impaired class if that class and all below it in priority are treated according to the absolute priority rule. A dissenting class must be paid *in full* before *any* junior class may share under the plan.

Id. at 413 (emphasis added).

The Code's provisions for class voting and application of the "fair and equitable" standard literally reversed the statutory scheme of the superseded Bankruptcy Act. Previously, any class vote rejecting a proposed plan resulted in the rejection of the plan. But a class vote in favor of a plan triggered application of the fair and equitable standard with respect to each creditor. Now, to the contrary, a class vote in favor of the proposed plan of reorganization results in its approval, whereas a class vote against a plan triggers application of the fair and equitable requirement as to the class as a whole.

A "new value" exception under the old law would have provided some modicum of protection of *creditors* against holdouts, but under the new law, that is no longer necessary. Under the Code, unlike under the Act,

majority creditors no longer have need of such protection, since minority votes can, by statute, be overridden, without the need for some sort of imaginary "new value" exception to the absolute priority rule.

The current law's codification of the absolute priority rule for Chapter 11 cases such as this one clearly does not contain any exception to the rule. It provides that a plan can be accepted by each impaired class of claims or interests. 11 U.S.C. § 1129(a)(7). If the plan is not accepted within the meaning of the statute it may, nonetheless, be confirmed if it "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." 11 U.S.C. § 1129(b)(1). "Fair and equitable," means, however, that "the holder of any claim or interest that is junior to the claims of such class will *not* receive or retain under the plan on account of such junior claim or interest *any* property. 11 U.S.C. § 1129(b)(2)(B)(ii) (emphasis added).

By contrast, bankruptcy proceedings under Chapter 13 or under Chapter 12 do permit the retention of property by the debtor in return for monetary contributions of a sort. A Chapter 13 plan (concerning the adjustment of debts of an individual with regular income) can be confirmed over the objection of the holder of an allowed unsecured claim, even if the holder will not receive the full value of his or her claim, if "the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan." 11 U.S.C. § 1325(b)(1)(B). Chapter 12 proceedings, pertaining to family farm bankruptcies, are governed by statutory language almost

identical to Section 1325. *See* 11 U.S.C. § 1225(b)(1)(B). Self-evidently, Congress knows how to preserve some of the junior interests of debtors, in derogation of the interests of senior unsecured creditors, when that is its intention. Yet it is equally self-evident that Congress chose not to do so with respect to Chapter 11 proceedings. It would have been a simple enough matter for Chapter 11 to have provided for confirmation of a plan over the objection of one or more classes of unsecured creditors if the equity owners were to make the type of monetary contribution that is expected of farmers and individuals in their respective proceedings. But Congress did no such thing. Instead, it required, in plain language, that objecting classes of senior creditors must be paid in full before junior classes (including equity owners) receive or retain *any* property.

CONCLUSION

Here, Bank of America, the sole creditor of its class, was not to be paid in full under the plan, but the equity owners were to retain an interest in the property. The bank objected to the proposed reorganization. As this Court has held, "[t]his was their prerogative under the Code, and courts applying the Code must effectuate their decision." *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 207 (1988). The Seventh Circuit failed to follow that directive, and its decision should be reversed.

Respectfully submitted,

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